



INTERNAL AUDIT CONTROLS EVALUATION COMMISSIONER OF THE REVENUE

April 4, 2005

Roanoke City Council Audit Committee
Roanoke, Virginia

We have completed our audit of the Commissioner of the Revenue's office. Our audit was performed in accordance with generally accepted government auditing standards.

BACKGROUND

The authority for having a Commissioner of the Revenue is set forth in the Constitution of Virginia. The duties enforced by the commissioner are primarily defined in Section 58 as well as other sections of the Code of Virginia. The primary duties performed by the commissioner are to maintain the property book, process elderly exemptions, issue business licenses, prepare and process state tax returns, and administer the short term rental tax.

According to the Commissioners of the Revenue Association of Virginia, equitable taxation and discovery of all taxable persons/businesses are the two most pressing duties for a Commissioner of the Revenue. In performing these duties, commissioners have extensive authority to question individuals and review any records to determine if taxes are due and how much is due. Local commissioners have to administer a wide variety of taxes, and these are often self reported by taxpayers. For one reason or another, the self reported returns are often incorrect. Failure to identify taxpayers that are incorrectly reporting taxes can have a significant impact on local revenues. One study conducted by the Virginia Association of Local Tax Auditors (VALTA) estimated that up to 70% of returns could be incorrect. The many benefits of auditing local taxes include uniform local assessments among industry groups/tax types, education of the business community on proper reporting, reduction in refund and appeal request, and gathering the information needed to accurately statutorily assess taxes.

The Business, Professional, and Occupational License Tax (BPOL or Business License Tax) is a tax on the gross receipts of a business. Businesses operating in the City that are subject to the Business License Tax must obtain a business license prior to transacting business. The license is renewed annually on or before March 1 of each year. The tax rate varies based on the type of work, product, or services the business provides or sells. Generally, businesses reporting \$100,000 or less in gross receipts only have to pay a flat \$50 fee. Over \$100,000, businesses typically pay between 14 cents per \$100 in gross receipts to 58 cents per \$100 in gross receipts, depending on the type of business. There are also flat rate and percentage based fees for certain types of business activities. Businesses must file their business license return with payment by

March 1 of each year for renewals or within 30 days of starting a new business to avoid a penalty.

The City's personal property rate set by Council is \$3.45 per \$100 in assessed value. This rate applies both to individual and business personal property. Individuals have to pay the personal property tax on all vehicles including aircraft, boats, buses, trailers, motor homes, motorcycles, and trucks. The tax applies to any vehicle that is garaged within the City, with certain exceptions. Business personal property is assessed on tangible personal property employed in a business located in the City on January 1 of each year. The tax includes vehicles, fixtures, machinery, and tools. For vehicles, the tax is assessed on any vehicles normally garaged or parked in the City regardless of the location of the business or owner. Businesses are required to submit a return itemizing property on or before February 15 of each year. The returns are then entered into the personal property tax system to generate bills for the April 15 mailing.

SCOPE

Our audit focused on procedures in place as of December 31, 2004, and transactions occurring from January 1, 2004, through December 31, 2004.

OBJECTIVES

The specific objectives of this audit were to evaluate the system of internal controls in place in the Commissioner of the Revenue's office to ensure that all personal property and business licenses taxes are assessed in accordance with the law.

METHODOLOGY

We reviewed literature provided by various state agencies and professional organizations to gain an understanding of the mandates and operations of the Commissioner of the Revenue's office. We reviewed the tax assessment computer systems in order to determine the validity and reliability of the data, as well as evaluating the program's functionality. We interviewed and observed the staff in the Commissioner's office in order to document their tax compliance processes. We evaluated the adequacy of the processes in addressing the inherent risks related to enforcing tax compliance. Based on this evaluation, we developed a test program to determine the effectiveness of the Commissioner's processes in ensuring equitable enforcement of the City's tax code. Our test plan included using audit software to analyze personal property data, business license data, and Department of Motor Vehicles (DMV) data. In those cases when anomalies were identified, we selected samples of records to undergo detailed review in order to better interpret the meaning of the data. We also conducted some of the suggested audit procedures from the Commissioners of the Revenue Association of Virginia to determine if businesses were operating in the City without a business license.

RESULTS

Finding 01 – Organization and Procedures

The Commissioners of the Revenue Association of Virginia and VALTA have various suggested audit procedures for BPOL and property audits. These procedures address the need to identify all persons and entities that should file taxes and the need to ensure the accuracy of all tax returns. Based on our review of the work performed in the Commissioner's office, many of the recommended discovery and compliance processes are not being performed.

The Commissioner's office has no business plan and therefore nothing that specifies the mandates of the office, the key businesses the office performs, the priorities of the office, or the resources needed to meet its mandates. There are no documented procedures for any of the functions in the department, including tax compliance auditing. There is no description of available reports or resources that Tax Compliance Auditors should utilize. There are no audit programs that detail how audits are to be conducted. There are no procedures in place to guide the type of audit work that is performed and that the work is of acceptable quality. Some audit procedures performed by the office are relied upon nearly exclusively, yet the procedures do not identify a significant sector of the incorporated service businesses in the City. There are no performance targets for auditors. There are a limited number of field audits conducted to verify the accuracy of the returns. Much of the audit work that is performed is focused on getting non-filers to file returns, and not auditing the accuracy of tax returns. There is insufficient emphasis placed on conducting audits. Tax Compliance Auditors spend much of their time filing and alphabetizing returns, keying data, and answering phones. Only a fraction of their time is actually devoted to audit projects. Job specific competencies for auditors are the same as for other staff and do not address audit tasks.

Based on our evaluation of the processes in place, it is probable that a significant number of businesses are not appropriately filing business license and business personal property returns. There is also little assurance that those businesses that are filing returns have accurately reported the value of their gross receipts and their business personal property. Businesses may not be aware of their tax responsibilities or how to fully comply with the law. Additionally, businesses that are filing appropriately will be at a competitive disadvantage if their competitors are avoiding their tax responsibilities.

Recommendation 01 – Organization and Procedures

The Commissioner's office should develop a strategic business plan. Based on the adopted business plan, the Commissioner's office should develop and document detailed processes for each functional area in the department, including tax compliance auditing.

The Commissioner's office should make every effort to incorporate VALTA's and the Commissioners of the Revenue Association of Virginia's recommended audit procedures

into their audit processes. The procedures should specify the reports and forms used, the audit programs to be followed, the documentation to be kept, etc. An emphasis should be placed on conducting a number of field audits each year, as these are the primary means of ensuring compliance.

The Commissioner's office should also evaluate the role of temporary staffing in addressing fluctuating work loads. Improved documentation of procedures would allow temporary staff to be utilized more effectively to perform data entry, filing, and answering the phone. This, in turn, would relieve full time staff of these duties and allow them to concentrate on their primary functions.

Finding 02 – Business Personal Property

State Code § 58.1-3519 requires that the Commissioner of the Revenue assess property at the fair market value if a taxpayer fails to submit a property tax return. Additionally, VALTA recommends that non-filers be audited because most businesses that do not file are either unorganized or are trying to avoid taxation. Auditing the businesses helps encourage compliance with the locality's tax laws.

We obtained a download of business personal property accounts for tax years 2002, 2003, and 2004. The original assessment and current assessment were included for both machinery & tools and furniture & fixtures. The download included 27,695 records. We analyzed the data and found that 14,467 of the records had zero values for all 4 of the assessment fields. A number of these could be explained based on having an exemption from personal property or due to having gone out of business over the three year period reviewed.

We selected a judgmental sample of 50 businesses that had zero values in all 4 fields and did not appear to be exempt from taxation. We then compared the businesses to a download from the business license system to determine if the business was active and needed an assessment. We believe that at least 27 of the 50 businesses reviewed should have had been assessed personal property tax for the tax year(s) reviewed. Based on our test work, there is a high probability that a significant number of businesses are not filing business personal property tax returns and, as a result, are not being assessed for personal property.

We noted that a zero balance report exists to identify businesses who have not filed business personal property. Based on our research with the Department of Technology, this report was not requested from 1998 through 2002. The report was requested in 2003, but was later determined to have a logic error causing it to not list some businesses that in fact had not filed personal property.

The tax assessment system is primarily designed to produce the assessments and property books, and provides only limited functionality related to audit procedures. The system provides the ability to enter notes about an account on the system, but will not produce follow up letters to businesses that have not filed. These letters are

produced by the Tax Compliance Auditor using a word processor. The Tax Compliance Auditor has not developed a method of tracking non-filers' responses to follow up letters. In 2004, the Tax Compliance Auditor mailed 963 letters to businesses that had not filed business personal property and received back only 265 responses. Additional follow up is not performed and field audits are not performed. Again, there are no performance goals established by the Commissioner's office related to the audit function. There are no documented procedures to ensure that responsibilities prioritized are performed efficiently and effectively.

Recommendation 02 – Business Personal Property

The Commissioner's office needs to develop methodology for identifying businesses that do not file personal property and the procedures to obtain an accurate return or produce an accurate statutory assessment. Currently, the audit procedures applied to business personal property are mostly aimed at getting non-filers to file. We recommend that the Commissioner's office incorporate VALTA's suggested audit procedures for property audits into its methodology, including using field audits to verify the accuracy of the returns. The ability to flag accounts in the tax system as exempt should be explored in order to reduce the amount of analysis required when reviewing zero balance accounts.

Finding 03 – DMV Audit

The City receives a file from the DMV weekly listing vehicles which have been newly registered as garaged in the City and vehicles that have been reported as moving out of the City. A program has been written to load the DMV data into the City's personal property system. The data then has to be reviewed and corrected by the Commissioner's office before being saved to the system. The Commissioner's office has historically not submitted the job request to run the DMV report during the busy tax season, which could range from January to June, in order to allow staff to do other work related to the mass billing for personal property. Once a weekly report is missed, it cannot be recaptured and cannot be worked later. The vehicle changes during this period will go unnoticed unless the owner reports them to the Commissioner personally.

In order to evaluate the possible effects of having not worked the weekly reports, we obtained a download of all vehicles in the City of Roanoke on March 1, 2005, from the DMV. We also obtained a download of vehicles in the City's personal property system. Using audit software, we compared the download of vehicles from the DMV to the City download. We identified a significant number of vehicles on the DMV system that were not on the City's personal property system. We selected a random sample of 50 of these vehicles purchased between January 1, 2004, and September 30, 2004, and believe that 14 of the 50 vehicles should have been assessed for personal property tax. Of the 14 vehicles that should have been assessed, 4 vehicles were garaged within the City during the time that the DMV report is turned off during the tax season. The remaining 10 vehicles were not added while the report was being requested from June 2004 to

October 2004; however, a logic error in the report resulted in the vehicles not being assessed. This error was corrected by the Department of Technology in October 2004. When the DMV report is not requested each week, our test work indicates that vehicles may not be assessed for personal property if the owners do not contact the City when a change in vehicle status is made. Also, the data in the personal property system will be inaccurate because drops are not processed; causing increased returned mail, inaccurate assessments, and inappropriate delinquencies.

Recommendation 03 – DMV Audit

The Commissioners of the Revenue Association of Virginia states that the discovery of all taxable persons/businesses is one of the most pressing items for a commissioner, and each commissioner should have in place detailed procedures to discover all taxable property as required by Code. The association also lists weekly, monthly, and yearly DMV lists as tools for tax discovery. We recommend that the weekly DMV job be requested and worked throughout the year. The Commissioner's office should request a report of all vehicles garaged in the City as soon as practical and request that the Department of Technology run it against the City's files and provide exception reports. The exception reports should be used to correct the City's personal property records. The weekly reports can then be used to maintain the records going forward.

Finding 04 – Business License Tax

City Code Section 19-5 states that "the license inspector and deputy license inspectors shall ascertain the name of each person engaged in conducting any business, occupation, profession or other activity in the city without having obtained a license..." As previously stated, the Commissioners of the Revenue Association of Virginia states that the discovery of all taxable persons/businesses is one of the most pressing items for a commissioner, and each commissioner should have in place detailed procedures to discover and find all taxable property as required by Code.

The Commissioner's office has no detailed, documented procedures that address the business license audit function. Many audit and discovery procedures recommended by the Commissioners of the Revenue Association of Virginia are not followed by the City of Roanoke. The Commissioner's office invests very little effort in field audits of businesses. The office, instead, invests its time in desk reviews of new state sales tax accounts reports and individual tax returns to identify non-filers and businesses under-reporting gross receipts. These reviews are incomplete since the sales tax report excludes service oriented businesses that do not pay sales tax and the Schedule C audits exclude most incorporated businesses.

Recommendation 04 – Business License Tax

We selected six City streets and chose 191 businesses operating on those streets to determine if the businesses had business licenses. We only noted a minimal number of businesses operating on those streets without businesses licenses. However, in order to

further strengthen the controls to ensure that all businesses operating in the City have business licenses and file accurate gross receipts, we recommend that the Commissioner's office implement the following Commissioners of the Revenue Association of Virginia suggested audit procedures:

- Obtain tenant rental information from renters or developers of commercial property.
- Regularly obtain listings of sub-contractors from contractors doing work in the City.
- Regularly canvas the City looking for new businesses.
- Audit new businesses within the first three to four years of operation to ensure the businesses know the filing requirements and are appropriately filing.
- Audit larger businesses to ensure gross receipts are accurately reported.
- Audit businesses or locations where other test work may be inconclusive.

Additionally, we recommend that the Commissioner evaluate the use of business license decals to be displayed on store fronts as an aid in monitoring businesses operating without a business license.

Finding 05 – Sales Tax Audit

The Commissioners of the Revenue Association of Virginia notes that matching the sales tax report to business license applications helps identify those businesses whose sales tax is being reported to another locality due to errors in the locality codes. We noted that the Commissioner's office does not review the sales tax report to identify businesses that may be paying sales tax to a different locality.

There is insufficient emphasis placed on performing audit work; and as a result, Tax Compliance Auditors are spending much of their time filing and alphabetizing returns, keying data, and answering the phones. Only a small portion of the year is actually devoted to audit projects. There are no formal, documented internal procedures that provide direction to the staff and ensure consistent, quality work. There are no audit programs, no descriptions of reports to print and work, no description of forms to be used, records to be created, file organization, or quality controls to ensure audits are reviewed for thoroughness and accuracy.

Recommendation 05 – Sales Tax Audit

The state sales tax report should be compared to the business license system at least annually to identify any businesses which may be remitting sales tax to another locality. Reports of surrounding localities can be requested to assist the Commissioner in finding businesses that may be remitting sales tax to another locality.

CONCLUSION

Based on the results of our audit work, we do not believe adequate processes and controls are in place to ensure all personal property and business license taxes are assessed equitably and in accordance with the law.

Pamela C. Mosdell, CIA, CISA
Information Systems Auditor

Michael J. Tuck, CPA, CGAP
Assistant Municipal Auditor

Drew Harmon. CPA, CIA
Municipal Auditor